Claiming an Ordinary Loss Under Section 1244 for an Investment in a Failed Start-up

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Authors:

Scott W. Dolson

Congress enacted Section 1202[i] based on the premise that the possibility of a $10 million gain exclusion would attract much needed capital for domestic start-ups. Congress also understood that while unicorns with billion-dollar valuations and stockholders reaping Section 1202's tax benefits grab headlines and perhaps drive investment in venture start-ups, the reality is that most investments in start-ups generate losses.[ii] This understanding led Congress to enact Section 1244[iii], which provides investors with a somewhat narrowly drawn and somewhat minor degree of tax relief when a corporate start-up fails.

Note that while this article refers to losses associated with investing in the stock of a start-up, the scope of Section 1244 is not limited to the stock of venture financed corporations, but also applies to long standing main-street businesses, so long as Section 1244's eligibility requirements are met.

Section 1244 basics.

Under Section 1244, an individual stockholder of a corporation or in some cases a partner in a partnership holding Section 1244 stock can claim an ordinary (rather than capital) loss of up to $50,000 per year (or $100,000 for on a joint return) from the sale or worthlessness of "Section 1244 stock." For most stockholders, an ordinary loss is much more beneficial than a capital loss. An ordinary loss provides a deduction from the stockholder's gross income, including wages, dividends, interest, 1099 income, and ordinary income passing through on Schedule K-1s. Section 1244 ordinary losses are not first offset against capital gains. Section 1244 losses not only reduce a stockholder's income taxed at the high ordinary income rates, but are also not subject to the annual $3,000 net capital loss limitation.

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Overall observations about Section 1244's benefits.

For the various reasons outlined below, Section 1244's benefits are not significant enough to merit structuring a business solely to qualify equity as Section 1244 stock. Nonetheless, many start-ups electing to operate through domestic C corporations for various reasons (e.g., obtaining venture financing or the benefits of Section 1202's gain exclusion) will be issuing "Section 1244 stock." For that reason, founders and investors should have some familiarity with the workings of Section 1244.

No election or filing is required when Section 1244 stock is issued.

There is no election required before issuing "Section 1244 stock" or after Section 1244 stock is issued. A corporation's organizational documents do not need to refer to Section 1244.[iv] The board of directors is not required to approve the issuance of Section 1244 stock. No filing with the IRS is required when Section 1244 stock is issued; nor is any filing required with the tax return for the year of issuance. Stockholders and management should maintain the records necessary to establish that stock qualifies as Section 1244 stock. These records include documentation necessary to establish that the corporation met the gross receipts test discussed below at the time of the issuance of the Section 1244 stock.

An ordinary loss from the sale or worthlessness of Section 1244 stock is reported on Form 4797, and if the total loss exceeds the maximum amount that can be treated as an ordinary loss for the year, the transaction should also be reported on Form 8949.[v] Section 1244 loss is treated as attributable to a taxpayer's trade or business for purposes of Section 172 (the provision governing net operating loss (NOL) carryovers).

There are extensive Section 1244 regulations.

Section 1244 has extensive Treasury Regulations addressing every aspect of how the provision functions. It seems ironic that the IRS has provided a wealth of guidance for a provision of arguably limited value to the venture community, while at the same time providing little useful guidance as to how the significant benefits of

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Section 1202 should be interpreted and applied. Nevertheless, familiarity with the regulations is important to an understanding of Section 1244's requirements.

What is "Section 1244 stock"?

The determination of whether stock qualifies as Section 1244 stock is made at the time of issuance. Section 1244 stock is common or preferred stock issued for money or other property by a domestic "small business corporation" (which can be a C or S corporation) that meets a gross receipts test. Common stock does not include securities convertible into common stock, nor common stock convertible into other securities.[vi] The stock can be voting or nonvoting stock.

A corporation qualifies as a "small business corporation" if at the time of the issuance of the stock in question, the total amount of money and property received by the corporation for stock (or as a contribution to capital or as paid in surplus) has not exceeded $1 million in the aggregate. This determination must be made each time Section 1244 stock is issued, and includes the amount received by the corporation with respect to the stock issuance being tested for Section 1244 qualification. The fact that Section 1244 status for stock issuances ends when the aggregate payments for stock exceed $1 million substantially limits the relevance of the provision. A corporation may designate the shares to be treated as Section 1244 stock in the year the $1 million threshold is exceeded. If the corporation does not make a designation, the remaining Section 1244 benefit is allocated among all shares issued during that year. Once the $1 million mark is surpassed, the corporation cannot issue additional Section 1244 stock in subsequent years.

Section 1244 stock cannot be issued for services, but an employee who is paid a cash bonus and subscribes for employer stock can be issued Section 1244 stock. Stock issued when debt is converted to equity can qualify as Section 1244 stock. Stock issued in exchange for stock generally doesn't qualify as Section 1244 stock, with certain limited exceptions for stock dividends, recapitalizations (qualifying as a Type "E" reorganization) and stock issued in Type "F" reorganizations. If Section 1244 stock is exchanged for other stock

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in the same corporation other than in a Type "E" reorganization (readjustment of the stock and securities of a corporation), the stock received in exchange is not Section 1244 stock. Further, a corporation must be a "small business corporation " (see above) at the time of an exchange for the replacement stock to qualify as Section 1244 stock. If Section 1244 stock is exchanged for stock in another corporation in any tax-free reorganization other than a Type "F" reorganization (mere change in identity, form or place of organization), the stock received in the exchange is not Section 1244 stock.

Stock doesn't qualify as Section 1244 stock unless more than 50% of the corporation's aggregate gross receipts within the five most recent taxable years ending before the date of the loss (or for the shorter period the corporation has been in existence) are derived from sources other than rents, royalties, dividends, interest, annuities, and sales or exchange of stock or securities (the "50% Test"). This 50% Test doesn't apply when the aggregate deductions allowed to the corporation (excluding operating loss carryovers and carrybacks and the corporate dividend received deductions) exceed aggregate gross income during the applicable period. In addition to the gross receipts test, the corporation must be an "operating company." A corporation has been held to be an operating company based on the company having operating assets, salaries and sales commensurate with a start-up company.[vii]

What triggers the claiming of an ordinary loss under Section 1244.

Stock must be sold or exchanged in order to claim a Section 1244 ordinary loss, or a determination must be made that the stock is worthless. A sale can include the complete liquidation of a corporation. The courts have said that the determination of when stock is worthless requires a facts and circumstances inquiry, often focused on a corporation's liquidation value and its potential value (i.e., is there a reasonable hope that the corporation's assets will exceed its liabilities in the future). Section 165 can provide some guidance on worthlessness but is not invoked when claiming a Section 1244 stock loss.

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Who is eligible to claim a Section 1244 loss?

Individuals (including spouses filing a joint return) and individual partners in partnerships (including LLCs taxed as partnerships) holding Section 1244 stock are eligible to claim a Section 1244 loss. Corporations, trusts, estates and trustees in bankruptcy are not eligible to claim a Section 1244 loss. A Section 1244 loss can be claimed only by an individual or partnership to whom the stock was issued and who has continuously held the stock until it is sold or is determined to be worthless. Stock is not Section 1244 stock if it is acquired from a stockholder, or as a gift, devise or as a distribution by a partnership.

If Section 1244 stock is held by a partnership, an individual who is a partner in a partnership at the time the partnership acquires the Section 1244 stock is entitled to share in the ordinary loss deduction in an amount equal to the lesser of the partner's distributable share of the loss at the time of the issuance of the stock or the partner's distributive share at the time the loss is sustained.

The IRS ruled in Technical Advice Memorandum (TAM) 9130003 and the Tax Court held in Virgil D. Rath, 101 TC 196 (1993) that S corporation shareholders do not qualify for an ordinary loss deduction under Section 1244 on the sale of a corporation's common stock held by the S corporation.

Aggregate dollar limits on claiming Section 1244 losses.

The maximum aggregate loss that may be treated by a taxpayer as ordinary loss for a taxable year with respect to an issuing corporation's Section 1244 stock is $50,000, or $100,000 for a husband and wife filing a joint return. Any loss in excess of the maximum allowable loss must be treated as a capital loss. For many investors, this annual loss limitation limits the practical significance of Section 1244. In most cases, the loss will occur in one tax year when stock is sold or becomes worthless. The cap on the ordinary loss may increase if the stock can be sold over two or more years.

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When computing a loss on Section 1244 stock, the stockholder must treat any increase in basis of the stock after issuance (through contributions to capital or otherwise) as applicable to non-Section 1244 stock.

S corporations as "small business corporations."

S corporations can issue Section 1244 stock. But typically, when an S corporation fails, previously allocated losses will have reduced a stockholder's tax basis in the Section 1244 stock (i.e., the S corporation stock) to the point where the additional ordinary loss to be claimed is at, or near, zero.

If you want to issue Section 1244 stock, don't use the "assets over" method for incorporating a partnership.

The "assets over" method is one of three methods addressed in Revenue Ruling 84-111 for converting a partnership to a corporation. In the "assets over" method, the partnership's assets are deemed to be contributed to the corporation in exchange for the corporation's stock, followed by the partnership's termination and distribution of its stock in liquidation. This method does not work for purposes of Section 1244, as Section 1244 stock status is not preserved when a partnership is deemed to distribute stock to its partners.

Making an election to convert a partnership to a corporation on Form 8832 (a "check-the-box election") will be deemed an "assets over" conversion. A state law conversion of a partnership to a corporation and the conversion of a partnership to a corporation effected by the merger of the partnership into a corporation are also deemed to be "assets over" conversions. Two partnership conversion methods that work for Section 1244 purposes are (1) the "interests up" method involving the contribution of partnership interests to the corporation in exchange for stock, and (2) the contribution of assets by a partnership, but only if the partnership retains ownership of the Section 1244 stock. Such conversions should be carefully documented to take advantage of the Section 1244 provision for ordinary loss treatment.

More Resources:

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In spite of the potential for extraordinary tax savings, many experienced tax advisors are not familiar with Qualified Small Business Stock or Section 1244 stock planning. Venture capitalists, founders and investors who want to learn more about Qualified Small Business Stock or Section 1244 stock planning opportunities are directed to several articles on the Frost Brown Todd website:

- Section 1202 Qualification Checklist and Planning Pointers
- A Roadmap for Obtaining (and not Losing) the Benefits of Section 1202 Stock
- Maximizing the Section 1202 Gain Exclusion Amount
- Advanced Section 1045 Planning
- Recapitalizations Involving Qualified Small Business Stock
- Section 1202 and S Corporations
- The 21% Corporate Rate Breathes New Life into IRC § 1202

Contact Scott Dolson if you want to discuss Section 1244 or QSBS issues by telephone or video conference. You can also visit our **QSBS & Tax Planning Services page** to get our latest insights and analysis.

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[i] References to "Section" are to sections of the Internal Revenue Code, as amended.

[ii] Studies show that between 30% and 90% of venture-backed start-ups fail. See Inc. Report: 75% of venture-backed start-ups fail. Review42 (updated February 25, 2021) reported that 90% of startups fail. Investopedia [better cite references needed here—I don't know where this is sourced from more specifically] reported that in 2019 the failure rate of startups was around 90%. And further reported that, according to business owners, reasons for failure included money running out, being in the wrong market, a lack of research, bad partnerships, ineffective marketing, and not being an expert in the industry.

[iii] This article focuses on Section 1244 issued after July 19, 1984. Other rules are applicable to stock issued prior to July 20, 1984.

[iv] Years ago, Section 1244 required the inclusion of a reference to the issuance of Section 1244 stock in a corporation's organizational

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documents and forms with this reference continue to circulate today.

[v] See the Instructions for Schedule D.

[vi] Note, Section 1244(d)(1)(A) provides a special rule which limits the amount of loss on Section 1244 stock that may be treated as ordinary loss. When Section 1244 stock is issued for property, if that property has an adjusted basis in excess of its fair market value, the basis for purposes of determining the amount of available Section 1244 loss is reduced by an amount equal to the excess, at the time of the exchange, of the adjusted basis of the property over its fair market value.

[vii] *Robert Schwartz*, T.C. Memo 1995-415.

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